

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Nakano, et. al. Analyst: John J. Pavalasky Bill Number: AB 1783  
Related Bills: See Legislative History Telephone: 845-4335 Introduced Date: 01-25-2000  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Exclusion/Gain from sale of qualified small business stock held more than 5 years/50% for stock purchased before effective date in 2000 & 100% for stock purchased after effective date in 2000.

### SUMMARY

Under the Personal Income Tax Law, this bill would increase to 100% the exclusion of gain on the sale of qualified small business stock purchased after the effective date of the bill and held for more than five years. The bill would retain the 50% exclusion of gain on the sale of qualified small business stock purchased before the effective date of the bill and held for more than five years.

### EFFECTIVE DATE

As a tax levy, this bill would be effective upon enactment and operative for taxable years beginning on or after January 1, 2000.

### LEGISLATIVE HISTORY

SB 671 (Ch. 881, Stats. 1993) enacted the 50% capital gain exclusion for small business stock; SB 1805 (Ch. 1243, Stats. 1994) codified act language from SEC. 28 of Senate Bill 671 (Stats. 1993, Chapter 881), relating to application of federal regulations to California's "stand alone" provision for the 50% exclusion; SB 715 (Ch. 952, Stats. 1996) adopted the federal tax law definition of "domestic corporation" (a corporation created or organized in the U.S. or any state) and also made technical, nonsubstantive changes that merely eliminated superfluous language; and AB 1120 (Ch. 69, Stats. 1999) removed the January 1, 1999, sunset date for the 50% exclusion.

### SPECIFIC FINDINGS

Under both federal and California law, noncorporate investors may exclude 50% of the gain realized and recognized on the sale or exchange of qualified small business stock that has been held for more than five years. The amount that a taxpayer may exclude as gain with respect to qualified small business stock issued by the same issuer is limited to the greater of \$10 million (\$5 million for married individuals filing separate returns) or 10 times the taxpayer's original basis in the stock of the issuing corporation.

To qualify as small business stock for federal purposes, the stock must be that of a "C" corporation. The total gross assets (treating all members of the same parent-subsidiary controlled group as one corporation) of the corporation at all times after August 10, 1993, and before the date of issuance, as well as immediately after the date of issuance, must not exceed \$50 million.

### Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ X PENDING

### Department Director

### Date

Gerald H. Goldberg

2/24/00

The corporation must meet certain reporting requirements. During substantially all of the taxpayer's holding period for the stock, the corporation (other than certain excluded corporations) must meet an active business test. The taxpayer claiming the exclusion must have acquired the stock when the stock was originally issued for money or other property (not including stock) or as compensation for services provided to the corporation.

To qualify as California qualified small business stock, the issuer must meet the following additional rules:

1. Must be doing business in California at all times on or after July 1, 1993;
2. Must have assets of \$50 million or less, when measured as a controlled group using modified federal rules, before the issuance of the stock; and
3. Must have at least 80% of the total dollar value of its payroll attributable to employment located in California.

For both federal and California purposes, one-half of the amount of gain excluded is treated as a preference item under the alternative minimum tax (AMT).

**This bill** would increase the percentage of gain excluded from income from 50% of the gain to 100% of the gain for qualified small business stock **purchased after** the effective date of these amendments in 2000 and held for more than five years. This bill retains the 50% exclusion of the gain for qualified small business stock **purchased before** the effective date of the amendments made by this bill in 2000 and held for more than five years.

One-half of the amount of gain excluded under this provision would continue to be treated as a preference item under the alternative minimum tax (AMT).

#### Implementation Considerations

Implementing this proposal would not significantly affect the department's programs and operations.

#### Technical Considerations

This bill does not specify which exclusion percentage would apply to qualified small business stock purchased on the effective date of the amendments in 2000, as paragraph (1) applies to stock purchased prior to the effective date of the amendments in 2000, and paragraph (2) applies to stock purchased after the effective date of the amendments in 2000.

The use of the word "purchase" was carefully avoided in the original drafting of this section due to disputes between taxpayers and the department that had arisen under the former small business stock section enacted in 1981 and repealed in 1988. It would be far preferable to tie the effective date of this new provision to the "original issuance" date provisions applicable under current law to avoid these disputes.

This section contains rules regarding (1) the length of the holding period for a conversion of stock, (2) the amount of gain from disposition by pass-through entities, (3) transfers by gift or death as well as (4) transfers in certain specified corporate reorganizations. However, these rules need to be revised to reflect the bill's enactment of 50% gain stock and 100% gain stock and the interaction with these transfer rules.

#### FISCAL IMPACT

##### Departmental Costs

This bill would not significantly impact the department's costs.

##### Tax Revenue Estimate

The revenue impact of this bill is estimated to be as shown in the following table:

Fiscal Year Cash Flow Purchases After Enactment Date Enactment Assumed On September 1,2000 \$ Millions		
2005-06	2006-07	2007-08
-\$15	-\$38	-\$50

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

##### Tax Revenue Discussion

The revenue impact of this measure would depend on the amount invested in qualified stock after the enactment date, the rate of growth of market value of qualified stock, and the amount of gains realized upon disposition after a minimum holding period of five years.

Estimates above are based on the same methodology used previously to project the impact of the current law extension of the 50% exclusion indefinitely. These estimates allow for the minimum five-year holding period requirement and the interaction with the tentative minimum tax. Allowance was also made for some taxpayers delaying purchases of qualified stock to meet the enactment date requirement.

#### BOARD POSITION

Pending.